BIRD WATCHING in LION Country

Leverage is not even a double-edged sword, it's a guillotine - and your head is on the block – PART 1

Dr Forex says - Let me explain to you once and for all that leverage is not what brokers allow you to use, it is what you decide to use.

At long last I am at the point where my Bird Watching in Lion Country Newsletter is ready for publication. If you haven't received one before, don't start searching amongst your spam filter emails. This is the first newsletter.

Choice of topic is a difficult matter but "leverage" was always high on the priority list for the first issue. Recently I once again realized clearly how misunderstood this vital concept was to all aspects of forex. In my mind there is no doubt that most of the trouble that forex traders have starts with leverage.

I will dedicate this first newsletter then to this concept – leverage and its destructive power in the retail forex trading world.

A few facts

- Personally I have not seen one wiped out trading account that wasn't leveraged too high.

- I have also no record of any sustained profitable trading account based on high leveraged, short-stop trading.

- I ask my mentoring clients early on what they believe are the reasons for previous losses. Most answers include something to do with leverage, not understanding it at all, or only partially, or underestimating it once they have understood it.

Leverage then, is …?

I get many questions, like the one below:

I'm reading your book and I'm really enjoying it. Can you provide me with the information where I can get 1:1 leverage with the company you mention on page 108 of your book? I'm using a demo with only $1500 in the account with 200:1 leverage and I'm a bit worried about this even on 1 mini contract with one currency.

Or:

I contacted the broker you suggested where I could trade with less than $10,000 with low leverage, but they only offer 50:1 leverage and not 3:1 like you suggest.

It is very clear that leverage is misunderstood and this misunderstanding is a root cause of forex trading losses and the futile attempts to overcome these losses without addressing the root cause.

Regulatory warnings that leverage is a double-edged sword that can work for or against you go completely unheeded, just as the warning “past performance is no indication of future performance” is flatly ignored.

Leverage is largely misunderstood because the marketing wizards of forex (your friendly forex broker) have done a slight-of-hand trick that shifted the focus from the very important fact of **how much the trader levers his trading capital to how much the forex marketing wizard is prepared to lend the trader.**

Everything you read about leverage has to do with the maximum leverage you can achieve and very little about the prudent application of leverage in a forex trading system. In other words, the broker is telling you how much he will allow you to leverage, if you want to, not how much you should leverage, if you know better.

Warren Buffet said – “Risk is not knowing what you are doing”.

People speak about 100:1 leverage – ***“I trade with 100:1”,*** without knowing what it means. I will show below how you are your greatest enemy by being ignorant about this vital concept. I hope many of you will get a very important **“AHA”** experience from the newsletter.

Definition of leverage

This is a general definition:

The mechanical power or advantage gained through using a lever.

A definition found at www.investorwords.com says leverage is:

The degree to which an investor or business is **utilizing borrowed money.**

Closer to forex trading: www.thefreedictionary.com

The use of credit or borrowed funds to improve one's speculative capacity and increase the rate of return from an investment, as in buying securities on margin.

Enter the concept of “margin”. Let’s make sure we understand what margin is:

Definition of margin

The amount of collateral a customer deposits with a broker when borrowing from the broker to buy securities.

This is exactly what you do if you open a forex trading account. You deposit collateral in order to be able to borrow currencies to trade currencies. Actually you don't have to borrow, but you can if you want to.

The moment that borrowing comes into play it is common knowledge that the amount that the lender will be prepared to lend has certain limitations. Obviously you can't lend indefinite amounts.

The thing that stumps most traders is the fact that the marketing wizards use the terms "leverage" and "margin" very loosely and interchangeably. This causes a lot of confusion. I believe this is done deliberately because it is in the forex broker's interest that traders do not see high leverage as a destructive problem but as an opportunity.

Let's make sure we understand first "leverage" and then "margin".

To understand leverage properly for trading purposes, let's use a well-known concept. You want to buy a house, you don't have the capital available, but you have a salary and can pay instalments on a regular basis, so you go to the bank and borrow money to pay for the house. **So you are leveraging your income / salary.**
There are limitations based on, amongst others, your income which means the amount you can borrow based on your income will be limited. There is a maximum you can borrow. Obvious, yes, but a very important concept for the lender – the maximum he should lend you in order to get the maximum return on his capital without overexposing himself to risk of default on your side.

(Just a thought from the sideline. If trading forex is mostly with borrowed funds why don't the brokers ask interest? Think about that ….)

Remember this: The lender is focused on maximums whereas the borrower should be concerned with minimums - borrowing as little as he can but still getting bang for his buck.

Now we turn to your trading account: you want to increase your speculative capacity by leveraging your investment, therefore you borrow money to trade with from your broker.

Before your broker will lend you money you have to put down margin, which you wish to lever. Your broker, being a prudent businessman has calculated his risk beforehand and is quick to tell you what the maximum is he will allow you to borrow from him. In forex it is typically one hundred times your capital but it can also be two hundred times your capital or even four hundred times your capital. This is one part of the equation:

"Dear valued customer, you will be able to leverage your money 100:1, (200:1, 400;1). We hope we can have a long and mutually beneficial relationship."

The other side of the equation is how much of this available borrowing you want to utilize in your speculative endeavours.

How much leverage you apply is your own decision and not something the broker can force on to you.

Here is proof:

We are going to start with a stock market example.

You open a trading account with a stockbroker, with say, $10,000. You can buy stocks to the value of $10,000. Let's say you did. **Did you leverage your funds?**

No. You didn't borrow a cent from the broker. You have $10,000 and the value of your stocks when you purchased them was $10,000 (ignore costs for the moment).

How do you calculate your leverage?

You divide your capital into the value of your transaction and express it as a ratio of "value of transaction" : "capital".

In the above example you divide $10,000 / $10,000 = 1:1

Well, your friendly online stockbroker one day sends you a message that they now **allow margined trading** and you can borrow funds to purchase stock up to the value of your current stocks. For simplicity sake we say the value of your stocks is still $10,000. In other words you can now buy another $10,000 worth of stocks while your capital input remains $10,000.

You do this after you just received a hot tip and now you have a transaction value of **2 X $10,000 = $20,000 divided by your capital of $10,000 = leverage of 2:1.** Or you can choose not to, it depends on you.

Vital for the broker: Maximum leverage allowed

The maximum leverage you can apply (as opposed to how much you want to apply) is your broker's decision:

The important thing you have to note in the above example is that **you have utilized all the leverage you were allowed by the broker.** This is vital. The broker takes a huge risk to lend you money and therefore they have certain rules which you must adhere to. There is a limit to what you can borrow from them. **In the above example the limit is leverage of 2:1 or seen from another viewpoint margin of 50%.** You must have at least half the value of your total transaction available in margin (in other words collateral in case you aren't as hot a trader as you thought).

Margin is usually expressed as a percentage, while leverage is expressed as a ratio.

The marketing wizards of forex realized that the fact that they can offer very high leverage will be to their advantage to lure online investors from the traditional markets. Furthermore, many online investors' portfolios were devastated by the 2000 crash and losses of up to 90% of formerly lucrative stock portfolios became commonplace – much of this leveraged through stock option schemes.

As a result they started to tout from the rooftops that leverage of 100:1, 200:1, and with the introduction of mini accounts, even 400:1 and 500:1 was available.

Terms like “trade with 100:1” leverage became the order of the day.

An unsuspecting and clueless online trading public swallowed this hook, line and sinker and were trading with “100:1 and 200:1 leverage”, not understanding what they are doing.

In reality the broker simply said “we will allow you to lever your margin up to 100:1, 200:1 or 400:1 at the absolute maximum, if you utilized all your borrowing power with us.”

But you must remember leverage is a double-edged sword. It can work for you and against you. And so a race started amongst the forex losers out there: where were the highest leverage, lowest margin and narrowest spreads being offered? As if this lethal combination would contribute to success...

So if you go to your friendly broker who offers both 100K lots and 10K mini lots you will find that on 100K lots you usually have a maximum of 100:1 leverage and on mini accounts 200:1 or 400:1.

So that is from the angle of the forex broker: They will allow maximum leverage of 100:1, 200:1, 400:1.

Vital for the trader: Minimum leverage needed

How does leverage look from your (the trader’s) side?

The question from your side is: How much margin do I need to trade a transaction of a certain value? The answer is simple, if they offer that I can lever my funds 100 times, then it is 1 / 100 = 1%, 1 /200 = 0.5%, 1/ 400 = 0.25%.

If we return to the stock market example the question of minimum leverage doesn’t play a role because if you have limited funds it would be prudent to buy low priced stocks in order to be able to invest in a basket of stocks.

But in the forex market where the minimum transaction values were initially 100K or 10K and a shell-shocked online trading public were lured to utilize the “advantages” of the high leverage with accounts of just $2,000 - $3,000 or mini accounts of $200 - $300, the minimum leverage certainly played a role.

To make all of this stick better I am going to use a real example:

A few years ago a now defunct tip service company did a survey on the typical forex trading account trading with 100K lots. The average sized account was an account of $6,000.

There is no question that the average trader will have to borrow money from the broker, ie leverage his funds. The question is “how much”? **To do a minimum transaction of 100,000 you divide the 100,000 by 6,000 and there is the answer: 100,000 / 6,000 = 16.67.**

In other words, he must borrow 16.67 times his money to do a minimum transaction and thus utilize a **minimum leverage of 16.67:1.** Just to do one silly trade.

Trading successfully: Know your real leverage

I am not going to be too technical about the exact leverage in these examples.

In reality if you have a US dollar account you should express the transaction value in US dollars before you calculate the exact leverage. So if you trade 100,000 GBPUSD, you actually trade dollars to the value of £100,000 which is at time of writing about $190,000. **There is a big difference between $100,000 and $190,000.** *(As Warren Buffet said: Risk is not knowing what you are doing …)*

With the flexibility offered by mini lots (10K), micro lots (1K) and variable lots (any size the trader defines) it is easier these days to determine one's real leverage because you operate within the extremes of minimum leverage and maximum leverage.

Let's return to the questions above:

Can you provide me with the information where I can get 1:1 leverage with the company you mention on page 108 of your book? I'm using a demo with only $1500 in the account with 200:1 leverage and I'm a bit worried about this even on 1 mini contract with one currency.

"Can you provide me with the information where I can get 1:1 leverage?"

Considering that leverage is transaction value divided by capital the important aspect is your capital and the minimum position size because to be in a position to trade 1:1 you must have at least the same capital as the minimum transaction. In your case you will have to trade with a broker that offers variable lots or micro lots not larger than 1,500 units.

"I'm using a demo with only $1500 in the account with 200:1 leverage"

You refer here to the maximum leverage or the maximum amount they will allow you to borrow. This is a fixed amount (percentage) applicable to all transactions and it does not affect your transactions at all, as long as you stay within this limit.

"I'm a bit worried about this even on 1 mini contract with one currency."

First of all there is no need to worry about the "200;1 leverage". It simply means it is the maximum you are allowed to trade, not what you are forced to trade (it's your choice!). To trade the maximum would really be silly. Your real leverage if you trade one mini contract with $1,500 will be in the region of 6:1 or 7:1. (10,000 / 1,500).

It is interesting that you mention one currency also, because you must know that if you simultaneously trade 2 or 3 currencies your leverage increases. Say you trade one mini lot EURUSD, GBPUSD and USDCHF, the total value of units = 30,000 (3 mini lots) and your capital is still $1,500.

Your leverage is thus 30,000 / 1,500 = 20:1. That's high. You borrow 20 times what you have.

To trade forex profitably you need a $3.00 calculator not $300.00 a month charting service.

Here is the proof:

Let's talk about the 200:1 "leverage".

I hope by now you understand that **this refers to the maximum the marketing wizard will allow you to borrow** and that you can borrow much less to keep your leverage sane and your account afloat. But if you go to that extreme you must be really desperate or stupid and for all practical purposes you are already on the way out.

So what the forex marketing wizards call "leverage" is actually the margin requirement expressed as a ratio instead of as a percentage, which makes more sense and has absolutely no impact on your trading, unless you are already basically wiped out or about to be.

Let's say a trader has $10,000 and trades at a broker which offers "flexible leverage".

You can choose your "leverage", 400:1, 200:1, 100:1 or 50:1. What they mean is you can choose your margin requirement (which will define the maximum you can borrow from them) to be 0.25%, 0.5%, 1% or 2% of the transaction value.

Trader decides to buy 5 mini lots EURUSD, ie €50,000 transaction value and the value of one pip on this transaction is $5.00. Let's say he makes 100 pips profit which is $500 or 5% of his capital.

Does the flexible margin requirement, generally called "leverage" affect this outcome?

The answer is "no".

- Leverage = 400:1 = 0.25% = $25 X 5 = $125. After 100 pips move the Trader makes $500.

- Leverage = 200:1 = 0.50% = $50 X 5 = $250. After 100 pips move the Trader makes $500.

- Leverage = 100:1 = 1.00% = $100 X 5 = $500. After 100 pips move the Trader makes $500.

- Leverage = 50:1 = 2.00% = $200 X 5 = $1000. After 100 pips move the Trader makes $500.

It is vitally important that you grasp this:

The only variable in this whole trading exercise is the real leverage, not the margin requirement.

In the example above the market moved 100 pips irrespective of the margin required.

The only differentiating factor is how much the trader borrows out of what is available. Depending on how much trader borrows he will have a different outcome.

In the example he borrowed 5 times his capital, was levered 5:1 and made $500.00. If he borrowed ten times his capital and was levered 10:1, he would have made on the same market move $1,000 or 10% of his capital. If he borrowed two times his capital 2:1, 2% and so on.

Margin – Leverage - Risk

People incorrectly think the risk they take has to do with the margin requirement, forex marketing wizard's "leverage".

How many times have you come across money management or risk management systems that say **you must not risk more than x% of your capital on a trade?**

Let's say our Trader used this technique and he doesn't "risk more than 10% of his capital" on a trade.

In the example above in the case of 2% margin (50:1 "leverage") the Trader "uses" 10% of his capital (as margin). (Hopefully you now realize that in reality he risks his capital 10 times!)

So if the approach is that the risk is determined in terms of the margin that is being "put up" on a per trade basis the following applies: **Out with the calculators!**

Trader has $10,000 and is prepared to "risk 10%"

- Leverage = 400:1 = 0.25% 10 / .25 = 40. That is, 10% "risk" will be 40 lots or 400K. Real leverage = 400 / 10,000 = 40:1. Pip value = $40.00.

- Leverage = 200:1 = 0.50% 10 / .50 = 20. That is, 10% "risk" will be 20 lots or 200K. Real leverage = 200 / 10,000 = 20:1. Pip value = $20.00

- Leverage = 100:1 = 1.00% 10 / 1.00 = 10. That is, 10% "risk" will be 10 lots or 100K. Real leverage = 100 / 10,000 = 10:1. Pip value = $10.00

- Leverage = 50:1 = 2.00% 10 / 2.00 = 5. That is, 10% "risk" will be 5 lots or 50K. Real leverage = 50 / 10,000 = 5:1. Pip value = $5.00

This same risk management strategy then usually says, don't risk more than x% of your capital in potential losses, therefore calculate your stop-loss point beforehand as a percentage of capital. So a stop-loss is typically set at 2% or 3% of capital.

In this case, if 2%, the maximum loss value will be $200 (2% of capital of $10,000). But as you have seen now, the first part incorrectly calculates pip value based on a bogus principle (for the leveraged trader), while the trader supposedly "risks" 10% of his capital in all four cases.

- Leverage = 400:1, Pip value = $40.00, "risk 10%". The stop-loss of 2% must be 5 pips.

- Leverage = 200:1, Pip value = $20.00, “risk 10%”. The stop-loss of 2% must be 10 pips.

- Leverage = 100:1, Pip value = $10.00, “risk 10%”. The stop-loss of 2% must be 20 pips.

- Leverage = 50:1, Pip value = $5.00, “risk 10%”. The stop-loss of 2% must be 40 pips.

The above clearly demonstrates that a misunderstanding of leverage can be devastating to your chances of success.

It also demonstrates that many so-called money management systems are absolutely bogus - spreadsheet theory - and have nothing to do with real profitable trading.

Suffice it to say that while the “400:1 and 200:1” options aren’t utilized that much you will be tempted by the 100:1 and 50:1 options as suggested by almost all the experts out there, accompanied by the necessary 20, 30 and 40 pip stops that are hit all the time (followed by the inevitable market movement in your initial anticipated direction).

Summary

- What is usually referred to as leverage is actually the margin required expressed as a ratio if you use all the borrowing power the broker will allow.

- Real leverage is determined by dividing your capital into the value of your positions.

- Real leverage can differ from trade to trade and increases with multiple simultaneous trades.

- Margin required has no influence on your risk if you trade properly with modest leverage within your means and is not to be used as a risk calculating principle.

Next time

Part 2 of “Leverage is not even a double-edged sword, it’s a guillotine”

Kind regards
Dirk D. du Toit

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